No. 479

In the Supreme Court of the United States

OCTOBER TERM, 1939

GUY T. HELVERING, Commissioner of Internal Revenue, PETITIONER

v.

CHARLES A. BRUUN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit, entered in the above-entitled cause on July 24, 1939, affirming a decision of the Board of Tax Appeals.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 30) is unreported. The opinion of the Circuit Court of Appeals (R. 43–46) is reported at 105 F. (2d) 442.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 24, 1939. (R. 47.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a lessor derives income in the year of the cancellation of a lease to the extent of the then value of a building erected by the lessee and forfeited to the lessor upon the termination of the lease because of its breach.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 22. GROSS INCOME.
>
> (a) GENERAL DEFINITION.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 63 [as amended by T. D. 4539, XIV–1 Cum. Bull. 141 (1935)]. *Improvements by lessees.*—If buildings are erected or improvements made by a lessee and such buildings or improvements immediately become the property of the lessor, as, for instance, if they are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(*a*) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(*b*) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

If the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor shall report income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on

account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included.

* * * * * *

STATEMENT

The facts were stipulated (R. 13–30) and they may be summarized as follows:

The taxpayer, at all times material here, owned a lot located in Kansas City, Missouri. On July 1, 1915, he leased the lot for a term of 99 years to the Newmarket Investment Company. At the time of the execution of the lease there was a building upon the property which had an undepreciated cost to the taxpayer of $13,365. During the year 1929 the lessee, as it was permitted to do under the lease, demolished and removed the building from the premises and during that same year it constructed a new building, which had a useful life of not more than fifty years. (R. 14.)

On July 1, 1933, the lessee being in default in the payment of rent and taxes, the lease was cancelled and the property, together with the buildings then thereon, turned over to the taxpayer. On that date the building which had been erected by the lessee had a fair market value of $64,245.68 and the unamortized cost of the old building removed by the lessee in 1929 was $12,811.43, leaving an excess of $51,434.25 in the fair market value of the new building as of July 1, 1933, the date the lease was cancelled. (R. 14.)

The Commissioner of Internal Revenue determined that the taxpayer, as a result of the termination of the lease, realized a net gain of $51,434.25, being the difference between $64,245.68, the value of the new building, and $12,811.43, the adjusted cost base of the old building. (R. 15.) The Board of Tax Appeals held that no gain was realized in 1933 (R. 30), and the Circuit Court of Appeals affirmed (R. 46).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that no taxable income resulted to the taxpayer in the year 1933 upon the premature termination of the lease, and his acquisition of the property including a building erected thereon by the lessee.

2. In failing to hold that the taxpayer realized a net taxable income in the amount of $51,434.25 during the year 1933 by reason of the termination of the lease by cancellation and his acquisition of possession of the property including the building erected thereon by the lessee.

3. In affirming the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. This case presents an important question in the administration of the federal income tax laws which is sorely in need of a clear and authoritative answer. For over twenty years the Treasury

has wrestled with the problem of how to tax the admitted gain which accrues to a lessor as a result of improvements added or buildings constructed by the lessee, and its task has been made a most difficult one by conflicting and uncertain judicial decision.

At an early date the Treasury took the position that improvements made by the lessee constituted taxable income to the lessor upon termination of the lease.[1] However, in 1919, the Circuit Court of Appeals for the Ninth Circuit held invalid the regulations which embodied that rule. *Miller* v. *Gearin,* 258 Fed. 225. The court said that the gain represented by the new building constructed by the lessee, if taxable at all, must be treated as having been realized when the building was first completed (p. 226). The Government sought further review, but this Court denied certiorari. 250 U. S. 667.

The Treasury thereupon undertook to accommodate itself to the court's decision. It amended its practice, and ruled that income was realized when the improvements were added in the amount

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[1] See Mimeographed Decision 2714, 4 Cumulative Bulletin 90, for a discussion of the history of the early rulings on this issue.

T. D. 2442, which set forth the practice, was promulgated on February 6, 1917, and was later embodied, with minor changes, in the revised edition of Regulations 33 (1916 Act), Article 4, paragraph 50, and in Regulations 45 (1918 Act), Article 48.

of their fair market value subject to the lease.[2] Provision was also made for imposing an additional tax at the premature termination of the lease to the extent that the value of the improvements upon such termination should exceed the income originally reported, subject to the condition, however, that such excess should not include any appreciation in value due to causes other than premature termination.

But it was held in 1935 that the new regulations were invalid. *Hewitt Realty Co.* v. *Commissioner*, 76 F. (2d) 880 (C. C. A. 2d). And a case finally reached this Court in which the Government hoped that the issue would be definitively disposed of. *M. E. Blatt Co.* v. *United States*, 305 U. S. 267. However, that decision appears to turn largely upon the facts there presented, and the Government strongly feels the need of a clear-cut adjudication on this question to dispel the existing confusion.

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[2] The new ruling appeared as T. D. 3062, 3 Cumulative Bulletin 109, 144, 171. This ruling was thereafter embodied in the 1920 edition of Regulations 45, Article 48.

Regulations 62, Article 48, promulgated under the Revenue Act of 1921, continued these provisions, and, as a concession to taxpayers, gave the lessor the option of reporting the depreciated value of the improvements either in full during the year they were added or to spread that amount over the life of the lease, reporting an aliquot part each year. These provisions thereafter reappeared from time to time with certain modifications and enlargements in the various regulations issued under the succeeding Revenue Acts. See Regulations 65 (1924 Act), Article 48; Regulations 69 (1926 Act), Article 48; Regulations 74 (1928 Act), Article

The question here involved has recurred under all the Revenue Acts and is presented in at least several cases now pending in the lower courts or before the Board of Tax Appeals.

2. The decision below is a misapplication of *M. E. Blatt Co.* v. *United States*, 305 U. S. 267. There the lease was still in effect, and while the owner's property had been improved without expense to it, the lessee was presently in possession. This Court held (p. 280) that the owner "had no right to use or dispose of them [the improvements] during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute."

The situation in the instant case is different. Here the lease has been forfeited and the respondent has come into full possession and enjoyment of the improvements, released from the rights previously held by the lessee. In this case there is not merely an enhancement in value, but an income-producing event has occurred of the character which, in comparable situations, has been held to result in taxable income. Thus, the release from a liability is equivalent to the receipt of income. *United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342; *United States* v. *Hendler*, 303 U. S.

63; Regulations 77 (1932 Act), Article 63; Regulations 86 (1934 Act), Article 22 (a)–13; Regulations 94 (1936 Act), Article 22 (a)–13; Regulations 101 (1938 Act), Article 22 (a)–13.

564, 566. Such cases support the Government's contention here that the acquisition by the respondent of the unrestricted right to use the new improvements supplies the element which was missing in the *Blatt* case. We therefore submit that the court below has made an unwarranted application of the *Blatt* decision. That decision has been similarly misapplied in *Nicholas* v. *Fifteenth Street Inv. Co.*, 105 F. (2d) 289 (C. C. A. 10th) and *Cleveland Trust Co., Trustee* v. *Commissioner*, 39 B. T. A. 113, which emphasize the need for an authoritative decision on this question.

3. In the broad sweep of its definition of gross income in Section 22 (a), *supra*, p. 2, Congress intended to make that definition co-extensive with its power under the Constitution. *Helvering* v. *Stockholms &c. Bank*, 293 U. S. 84, 89; *Douglas* v. *Willcuts*, 296 U. S. 1, 9; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88, 89; *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 233; *Irwin* v. *Gavit*, 268 U. S. 161, 166. The decision of the court below, therefore, really amounts to a holding that Congress is forbidden by the Constitution to tax the lessor with respect to the improvements added: that there has been no "realization" of income in the constitutional sense. Cf. *Eisner* v. *Macomber*, 252 U. S. 189. And in the *Hewitt Realty Co.* case, *supra*, the majority opinion made it quite clear that the question was one of constitutional power (p. 884).

To say that an owner of property has not realized anything when he comes into possession and finds a new building thereon is, we submit, to fly in the face of plain fact. It is difficult to believe that the Constitution was ever intended thus to circumscribe the power of Congress. For, it is firmly established that income may be received in the form of property and it seems impossible to imagine that the Constitution requires a distinction to be drawn between property affixed to the realty and property that is merely deposited thereon.

In view of the seriousness of the issue thus presented, it is important that this case be brought before this Court for further review.

CONCLUSION

For the foregoing reasons it is respectfully submitted that this petition should be granted.

ROBERT H. JACKSON,
Solicitor General.

OCTOBER, 1939.

U. S. GOVERNMENT PRINTING OFFICE: 1939